

TABLE OF CONTENTS

	PAGE
EXECUTIVE SUMMARY Click Here To View	i
<i>Recommendations</i>	ii
INTRODUCTION	1
SCOPE AND METHODOLOGY	2
BACKGROUND	3
<i>Chart I</i> <i>Organizational Chart For The Employee Services Division</i> <i>Of The Department Of Human Resources</i>	4
<i>Accomplishments Relating To Employee Benefit Funds</i>	5
FINDING I THE CITY CAN SAVE \$4.1 MILLION IN EMPLOYEE BENEFIT PAYMENTS WITHOUT COMPROMISING THE FISCAL INTEGRITY OF ITS EMPLOYEE BENEFIT FUNDS	6
<i>How The Budget For The Benefit Funds Is Developed</i>	7
<i>Overly Conservative Reserve And Expenditure Estimates</i>	7
• Life Insurance Reserves And Appropriations	8
<i>The City Should Improve On How It Calculates</i> <i>The Employee Benefit Funds Appropriations</i>	10
<i>Options To Address Overfunded Life Insurance Fund Reserves</i>	12
• Kaiser And Lifeguard Appropriation	13
TABLE I <i>Difference On Recalculated Appropriation</i>	16
<i>The Consequences Of Overly Conservative Expenditure Estimates</i>	17

Conclusion 18

Recommendations 18

ADMINISTRATION'S RESPONSE [Click Here To View](#) 20

APPENDIX A [Click Here To View](#)

DEFINITIONS OF PRIORITY 1, 2, AND 3

AUDIT RECOMMENDATIONSA-1

APPENDIX B [Click Here To View](#)

PROGRAM ACCOMPLISHMENTS MEMORANDUMB-1

INTRODUCTION

In accordance with the City Auditor's 1992-93 Audit Workplan, we have audited the City's Employee Benefit Fund Program. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

SCOPE AND METHODOLOGY

This is our first report on the City's Employee Benefit Fund Program. Our objectives were to determine whether the program is operating economically and efficiently and to identify opportunities for cost savings.

The findings in this audit report are the result of applying analytical auditing procedures during the preliminary survey phase of the audit process. For this phase of the audit, we studied and compared financial and non-financial information to identify appropriation and expenditure trends. We also subjected the City's Employee Benefit Fund Program to reasonableness tests, period-to-period comparisons, and budget to actual comparisons. Our specific procedures for this report included the following:

- We compared current period information with similar information for prior periods;
- We compared current period information with budgets; and
- We evaluated the City's methodology for determining employee benefit fund appropriations and reserves.

BACKGROUND

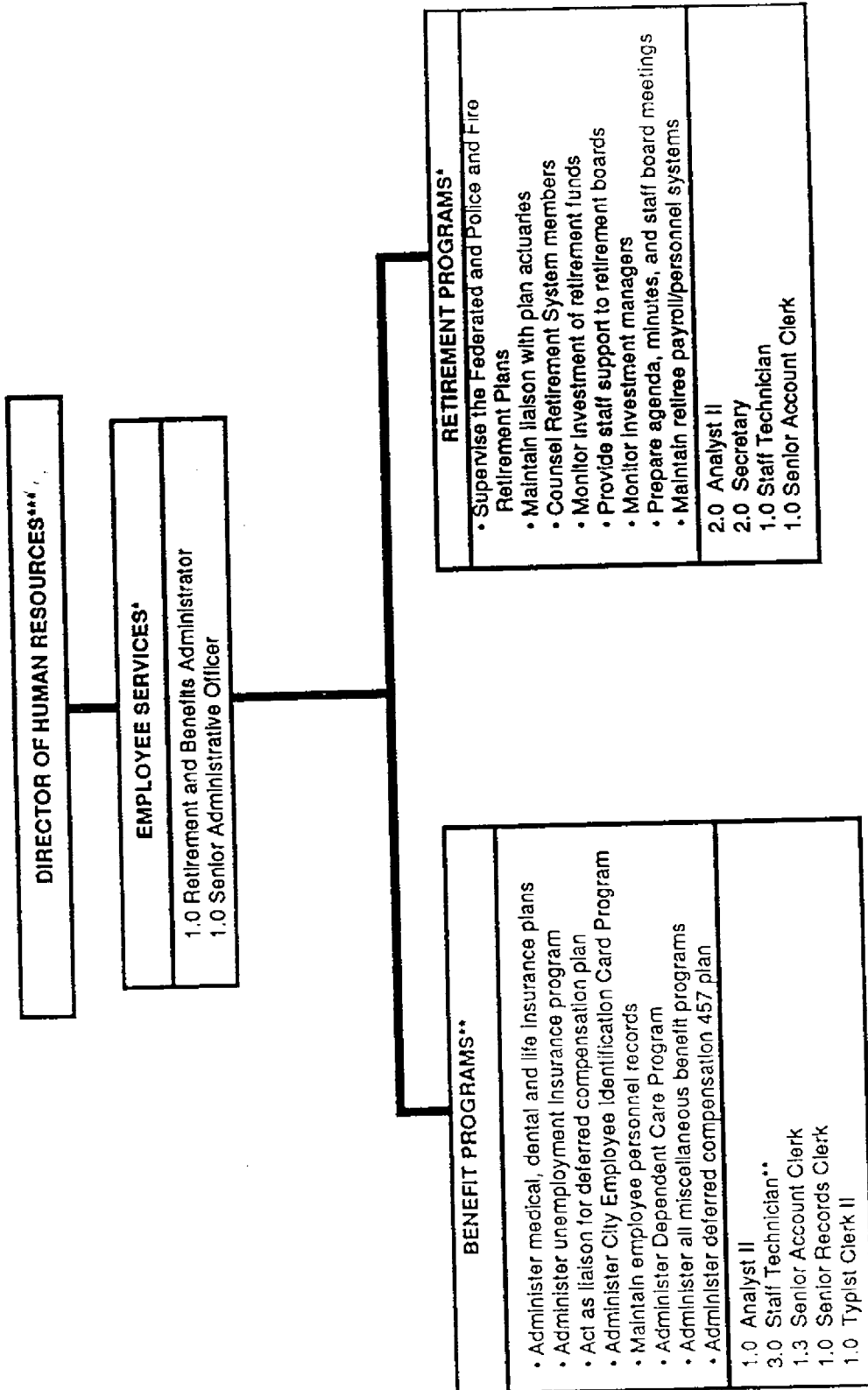
The City's employee benefit funds consist of the Dental Benefit, Life Insurance, Unemployment Insurance, Employee Benefit, and Employee Health Funds. These funds are internal service funds which are used to account for the financing of those services the Human Resources Department provides to other City departments and offices on a cost-reimbursement basis. The Employee Services Division of the Department of Human Resources is responsible for administering the City's benefit plans. The Division's specific responsibilities include overseeing the City's

- medical, dental, and life insurance plans;
- unemployment insurance program; and
- other miscellaneous benefit programs, such as Deferred Compensation and Legal Assistance.

Chart I shows the organization of the Employee Services Division of the Department of Human Resources.

CHART I

ORGANIZATIONAL CHART FOR THE EMPLOYEE SERVICES DIVISION OF THE DEPARTMENT OF HUMAN RESOURCES



*Police and Fire Retirement Fund and Federated Retirement Fund cover funding for 3.5 positions each.

**2.0 Staff Technician positions are budgeted in Employee Benefits Special Fund.

*** These Division reports to one of the two Deputy Directors in the Human Resources Department.

Accomplishments Relating To Employee Benefit Funds

In Appendix B, the Human Resources Department informs us of its accomplishments in the administration of the City's Employee Benefit Fund Program. According to the Director of Human Resources, the Department has maintained the qualitative aspects of the benefits program over the past 15 years. Cost reduction objectives have been exceeded by 5 percent to 15 percent per year.

FINDING I

THE CITY CAN SAVE \$4.1 MILLION IN EMPLOYEE BENEFIT PAYMENTS WITHOUT COMPROMISING THE FISCAL INTEGRITY OF ITS EMPLOYEE BENEFIT FUNDS

As part of its annual budget, the City appropriates funds to cover anticipated expenditures for various employee benefit funds. Our review of the employee benefit fund appropriations revealed that the City was overly conservative when it estimated the funds needed in the 1992-93 budget. Specifically, we found the following:

- Beginning in 1988-89, the City and its employees have contributed too much for life insurance. As a result, actual life insurance reserves exceed the Human Resources Department's own reserve requirements by \$2.3 million. The City's share of this excess reserve is \$1.3 million. In addition, the City can save about \$697,000 by not contributing its 1992-93 appropriation for life insurance.
- From 1991-92 to 1992-93, the City increased its Kaiser and Lifeguard appropriation more than necessary to accommodate actual Kaiser and Lifeguard plan increases. As a result, the City can reduce its Kaiser and Lifeguard appropriation by \$2.1 million.

By adopting the City Administration's proposed health benefit rate changes, reevaluating benefit fund program reserves and appropriation amounts, further adjusting, suspending, or rebating benefit fund contributions, and improving on how it calculates the benefit fund appropriations, the City could save as much as \$4.1 million in 1992-93 and ensure accurate and reliable expenditure estimates in future budgets.

How The Budget For The Benefit Funds Is Developed

The City Manager's Budget Office oversees the preparation of the City's operating budget. With regard to the employee benefit funds, both the Budget Office and the Human Resources Department make independent projections of revenues and expenditures and then resolve any differences.

In determining life insurance reserves, the Human Resources Department does not use actuaries to calculate the required amounts. Instead, the Human Resources Department developed its own standards for reserves based on an analysis of the time required to pay claims as well as on generally accepted industry standards.

In a memorandum dated May 20, 1992, the Human Resources Department informed the Budget Office of the target rates for claims reserves in the various benefit funds. These target rates are as follows:

Fund	Fund Name	Reserve Target
155	Dental Benefit	3 months of projected claims
156	Life Insurance	2 years of projected claims
157	Unemployment Insurance	4 quarters of projected claims
160	Employee Benefit	Not applicable
161	Employee Health	4 months of projected claims

Overly Conservative Reserve And Expenditure Estimates

As part of our audit of employee benefit funds, we reviewed the reasonableness of the appropriations for the City's employee benefit funds. Our review of the employee benefit fund appropriations indicated certain overly conservative estimates in the 1992-93 budget. Specifically, our audit revealed the following:

Life Insurance Reserves And Appropriations

Beginning in 1988-89, the life insurance amounts the City, its employees, and retirees contributed have exceeded actual claims, resulting in reserves exceeding the Human Resources Department's reserve requirements by \$2.3 million. We estimate the City's share of this excess reserve is \$1.3 million.

The City's Statement of Source and Use of Funds for the Life Insurance Fund shows a total beginning fund balance of approximately \$3,258,000 for the 1992-93 Proposed Operating Budget. The composition of this balance is:

Restricted Claims	\$1,900,000
Unrestricted	<u>1,358,000</u>
Total Beginning Fund Balance	<u>\$3,258,000</u>

The Statement of Source and Use of Funds also shows a 1992-93 budget for payment of claims of \$950,000. However, actual claims expenditures for the last five years have been as follows:

<u>Fiscal Year</u>	<u>Amount</u>
1987-88	\$ 818,945
1988-89	465,397
1989-90	293,500
1990-91	366,000
1991-92	<u>404,250</u>
Total	<u>\$2,348,092</u>
Annual Average	<u>\$469,618</u>

As shown above, the average annual cost for claims expenditures for the last five fiscal years was about \$470,000. As discussed previously, the Human Resources Department stated in its May 20, 1992, memorandum that the target rate for claims reserves for the Life Insurance Fund (Fund 156) is two years of

projected claims. Using the five-year average of claims as the amount for the annual projected claims, we estimate that the required target of two-year reserves should be approximately \$940,000. Thus, the restricted claims balance of \$1,900,000 plus the unrestricted fund balance of \$1,358,000 represent about 6.93 years of projected claims expenditures. Consequently, the total reserves for the Life Insurance Fund exceed the target by approximately \$2,318,000. Of this amount, we estimate that the City's share is \$1,321,000. We based our estimate on the percentage of life insurance coverage the City pays versus the percentages employees and retirees pay.

Further, assuming that the General Fund contributes about 70 percent of the City's cost, we estimate that the General Fund's share of the excess reserves is \$925,000.

The excess life insurance reserves accumulated to their current balances as a result of several years of overly conservative appropriations as is shown in the following comparison between Life Insurance Fund appropriations, actual expenditures, and ending fund balances for the last seven fiscal years.

<u>Fiscal Year</u>	<u>Life Insurance Appropriations</u>	<u>Life Insurance Expenditures</u>	<u>Appropriations Over <Under> Expenditures</u>	<u>Ending Fund Balance</u>
1985-86	\$550,000	\$272,814	\$ 277,186	\$2,153,986
1986-87	550,000	664,849	(114,849)	1,731,845
1987-88	600,000	818,945	(218,945)	1,229,107
1988-89	800,000	465,397	334,603	1,537,286
1989-90	800,000	293,500	506,500	2,154,908
1990-91	850,000	366,000	484,000	2,742,541
1991-92	950,000	404,250	545,750	3,257,986
Total			<u>\$1,814,245</u>	

As is shown above, excessive Life Insurance Fund reserves began to accumulate in 1989-90.

**The City Should Improve On How It Calculates
The Employee Benefit Fund Appropriations**

The City should improve on how it calculates the employee benefit fund appropriations. In 1988, the City increased the life insurance contribution rate from \$.09 to \$.19 per \$1,000 per pay period due to a substantial increase in claims during 1987-88. The City continued to use the same \$.19 per \$1,000 per pay period contribution rate to calculate life insurance appropriations for 1988-89 through 1991-92 in spite of the fact that actual claims during those years averaged less than half of the 1987-88 claims. The following were the actual claims expenditures for 1987-88 through 1991-92.

<u>Fiscal Year</u>	<u>Amount</u>
1987-88	\$818,945
1988-89	465,397
1989-90	293,500
1990-91	366,000
1991-92	404,250

As a result of the relatively low claims experience beginning in 1988-89, the Life Insurance Fund balance is currently \$3.2 million.

In the past, the City reduced excess reserves by lowering the rates charged to the City departments and the City employees. In a memorandum dated July 21, 1992, to the City Council, the Human Resources Department recommended approval of a proposed funding agreement with West Coast Life Insurance Company reducing the biweekly life insurance premium from \$.19 to \$.13 per \$1,000 per pay period and ensuring the fiscal soundness of the City's life insurance program. By lowering the premium, the Department anticipated the unrestricted balance would be used over the next four years. The Department said it would analyze the reserves annually to determine if any further adjustment needed to be

made. Our review of the supporting documentation for the \$.13 per \$1,000 per pay period indicated the following discrepancies:

1. The computation of the life insurance rates charged to City departments and City employees includes an amount estimated for payment of claims of \$950,000, which is overstated based on historical experience. Thus, if yearly claims are less than the \$950,000 level, it will take longer than four years to eliminate the unrestricted fund balance.
2. The computation of the life insurance rates also includes a projected amount of \$1,900,000 as a two-year claims reserve. This amount is also overstated based on historical experience. Thus, if the claims reserve amount is overstated, it will take longer than four years to eliminate the unrestricted fund balance.
3. The Human Resources Department has not used the life insurance contribution rate it calculates for determining the amount of budget appropriation needed. For example, for 1991-92, the Department calculated a life insurance contribution rate of \$.124848 per \$1,000 per pay period but adopted and used a rate of \$.19 per \$1,000 per pay period for appropriation purposes. In the 1992-93 budget rebalancing proposal, even though the Department's calculated rate indicated that no charge to City departments or City employees was needed at all, the Department used a rate of \$.13 per \$1,000 per pay period.
4. The Human Resources Department is not consistent in the application of its target rates for the Life Insurance Fund. For example, in its May 20, 1992, memorandum to the Budget Office, the Department stated that its life insurance reserve target was two years of projected claims. However, in its July 21, 1992, memorandum to the City Council, the Department said the Administration's objective is to maintain a reserve equal to two to three years of claims.

In fairness, it should be noted that according to the Human Resources Department, it has taken a conservative approach regarding any reductions to the

Life Insurance Fund reserves in order to protect the City against a catastrophic loss year. For example, if three or four upper management employees died in the same year, a reserve of \$1 million could be eliminated. In our opinion, while the Department's position is theoretically correct, maintaining a Life Insurance Fund reserve that exceeds historical requirements seems unnecessary given that the Department can always request additional funding if necessary or adjust life insurance contribution rates upward as it did in 1988.

**Options To Address Overfunded
Life Insurance Fund Reserves**

The City has a number of options available to address the \$1.3 million in excess Life Insurance Fund reserves identified in this report. These options are as follows.

- *Further Adjusting Life Insurance Fund Contribution Rates.* As was noted in this report, the Administration has already adjusted contribution rates downward for life insurance from \$.19 per \$1,000 per pay period to \$.13 per \$1,000 per pay period. Our review revealed that further downward contribution rate adjustments for both the City and employees are indicated and appropriate. It should be noted that adjusting contribution rates is the most conservative and slowest means to reduce excess employee benefit fund reserves. Accordingly, we estimated that it will take approximately five years to eliminate excess Life Insurance Fund reserves if contribution rates were further reduced from \$.13 per \$1,000 per pay period to \$.03 per \$1,000 per pay period. We estimate a contribution rate of \$.03 per \$1,000 per pay period would save the City \$587,000 in 1992-93, of which \$411,000 would be General Fund savings.
- *Suspending Life Insurance Fund Contributions.* Another option to reduce excess employee benefit fund reserves is to suspend the City's payments to the Life Insurance Fund. For 1992-93, the City's appropriation for life insurance is \$697,000, of which about \$488,000 is

General Fund. We estimate that it will take about three years to eliminate the \$1.3 million excess Life Insurance Fund reserve if the City's contribution to the Life Insurance Fund is suspended. Suspending employee contributions to the Life Insurance Fund may not be an option, given complications arising from employee bargaining unit agreements or other eligibility considerations.

- *Rebating Life Insurance Fund Contributions.* A third option to reduce excess employee benefit fund reserves is to rebate such excess reserves back to the City. By so doing, we estimate that \$1.3 million (\$925,000 General Fund) could be rebated back to the City in 1992-93.
- *Transferring Excess Life Insurance Funds To Other Employee Benefit Funds.* A final option to reduce excess employee benefit fund reserves is to transfer excess Life Insurance Fund reserves to other employee benefit funds that may need additional funding.

Further, it should be noted that the options shown above are not mutually exclusive and various option combinations are possible. For example, the City could suspend its contributions to the Life Insurance Fund and rebate excess Life Insurance Fund reserves back to the City funds that contributed to those reserves. By so doing, the City would save about \$2 million in 1992-93, of which \$1.4 million would go the General Fund.

Kaiser And Lifeguard Appropriation

From 1991-92 to 1992-93, the City increased its Kaiser and Lifeguard appropriation more than necessary to accommodate actual Kaiser and Lifeguard plan increases. As a result, the City can reduce its Kaiser and Lifeguard appropriation by \$2.1 million.

The 1992-93 appropriation amount for Kaiser and Lifeguard expenditures was \$16,167,704. The 1991-92 adopted appropriation amount was \$13,532,530.

Thus, the 1992-93 appropriation amount represents an increase of approximately \$2.6 million or 19 percent. This increase in the appropriation amount is overly conservative as compared to the actual Kaiser and Lifeguard rate increases, which ranged from 1 percent to 8 percent from 1991-92 to 1992-93.

Kaiser and Lifeguard rate increases for full-time employees are summarized below.

ALL UNITS EXCEPT POLICE AND FIRE

	<u>Kaiser Family</u>	<u>Lifeguard Family</u>
City contribution for 1991-92 Fiscal Year	\$164.77	\$148.64
City contribution for 1992-93 Fiscal Year	\$169.35	\$156.32
Increase	\$4.58	\$7.68
Percentage Increase	3%	5%

	<u>Kaiser Single</u>	<u>Lifeguard Single</u>
City contribution for 1991-92 Fiscal Year	\$65.86	\$60.90
City contribution for 1992-93 Fiscal Year	66.84	\$61.70
Increase	.98	.80
Percentage Increase	1%	1%

POLICE AND FIRE

	<u>Kaiser Family</u>	<u>Lifeguard Family</u>
City contribution for 1991-92 Fiscal Year	\$164.77	\$150.56
City contribution for 1992-93 Fiscal Year	\$176.23	\$163.28
Increase	\$11.46	\$12.72
Percentage Increase	7%	8%

	<u>Kaiser Single</u>	<u>Lifeguard Single</u>
City contribution for 1991-92 Fiscal Year	\$65.86	\$60.90
City contribution for 1992-93 Fiscal Year	70.71	\$66.06
Increase	4.85	5.16
Percentage Increase	7%	8%

Kaiser and Lifeguard are Health Maintenance Organizations (HMO) that provide service to a defined population during a fixed period of time for a

predetermined rate. Thus, the factors which affect the level of appropriation are the increases in the health insurance rates and/or increases in the number of enrollees.

Working with the Budget Office, we recalculated the amount that the City should have appropriated for Kaiser and Lifeguard coverage in 1992-93 as shown below.

Actual 1992-93 Appropriation	\$16,167,704
Recalculated Kaiser And Lifeguard Appropriation For 1992-93	<u>15,080,000</u>
Excess 1992-93 Appropriation	<u>\$ 1,087,704</u>

Because of the use of incorrect rates, the City appropriated about \$1,087,704 more than necessary to cover the cost of Kaiser and Lifeguard coverage in 1992-93. Assuming that the General Fund contributes 70 percent of the City's cost, the General Fund's share of the excess appropriation is \$761,000.

Based upon actual payments for Kaiser and Lifeguard coverage in August and September 1992, we recalculated the amount that the City will pay for Kaiser and Lifeguard coverage in 1992-93 as shown on Table I.

TABLE I

DIFFERENCE ON RECALCULATED APPROPRIATION

Actual 1992-93 Appropriation	\$16,167,704
Recalculated Kaiser And Lifeguard Payments For 1992-93	<u>14,000,000</u>
Excess 1992-93 Appropriation	<u>\$ 2,167,704</u>

As shown above, the City appropriated about \$2,168,000 more than necessary to cover the cost of Kaiser and Lifeguard coverage in 1992-93. Assuming that the General Fund contributes 70 percent of the City's cost, the General Fund's share of the excess appropriation is \$1,518,000.

It should be noted that the \$1,080,000 difference between our recalculation of \$14,000,000 and the Budget Office's recalculated figure of \$15,080,000 lies principally in the fact that the Budget Office included vacant positions when it made its recalculation, whereas we did not include vacant positions in our recalculation.

In the City Administration's General Fund budget rebalancing proposal, the City has proposed a budget adjustment to reflect health plan rate changes that went into effect July 1, 1992, and will result in savings of approximately \$1 million to the General Fund. We recommend that the City Council approve the City Administration's rebalancing proposal. In addition, we recommend that the 1992-93 General Fund appropriation for Kaiser and Lifeguard be reduced an additional \$518,000* and the appropriation for other City funds be reduced \$650,000*.

* It should be noted that the \$518,000 and \$650,000 figures shown above relate to vacancy savings from the City's hiring freeze. According to the Budget Office, these amounts are only part of the total 1992-93 vacancy savings and that the Budget Office will be presenting the City Council with a full assessment of vacancy savings for the Mid-Year Budget Review.

The Consequences Of Overly Conservative Expenditure Estimates

Overly conservative expenditure estimates cause two primary problems for the City Council and the Administration. The first problem has to do with the City Council's role in the City's annual budget process. Specifically, the City Council frequently has to make difficult budgetary decisions because of limited City revenues and multiple unfunded, competing City needs. This is especially true during times of revenue shortfalls or uncontrollable expenditure demands. Accordingly, when overly conservative expenditure estimates are used in the budgetary process, the City Council cannot appropriate City funds for deserving activities or purposes that fall outside of the City Council's budgetary priorities for a given level of available funds.

Another problem with using overly conservative expenditure estimates for budgeting purposes is that the Administration cannot effectively monitor subsequent expenditures. Specifically, the more accurate and reliable the estimates in the budget, the more likely variances from those estimates will receive administrative attention and follow-up. Thus, by improving the reliability of its estimates, the Administration will be more inclined to investigate unusual variances from those estimates.

In our opinion, the Human Resources Department can improve on how it calculates the City's employee benefit fund appropriations, rates, and reserves by (1) utilizing historical experience as one of the criteria for its projections, (2) consistently adhering to its reserve target rates, (3) preparing written procedures on calculation of rates and proper handling of excess reserves, and (4) documenting the bases for appropriations. By so doing, the Human Resources

Department will ensure accurate and reliable expenditure estimates in the budget and allow the City Council to allocate funds according to its budgetary priorities.

CONCLUSION

Our review of the employee benefit fund appropriations indicated overly conservative estimates in the 1992-93 budget pertaining to the Life Insurance Fund and the Employee Benefit Fund (Kaiser and Lifeguard appropriations). To eliminate excess reserves, the City Administration should adjust, suspend, or rebate benefit fund contributions. Furthermore, the City should improve on how it calculates the benefit fund appropriations. By so doing, the City will ensure accurate and reliable expenditure estimates in the budget and allow the City Council to allocate funds according to its budgetary priorities.

RECOMMENDATIONS

We recommend that the Budget Office and the Human Resources Department:

Recommendation # 1:

Eliminate excess reserves by further adjusting, suspending, or rebating the life insurance charges to City departments and City employees. (Priority 1)

Recommendation # 2:

Improve on how they calculate the City's employee benefit fund appropriations and rates charged to City departments and City employees. (Priority 2)

Furthermore, we recommend that the City Council:

Recommendation #3:

Approve the City Administration's proposal to reduce the 1992-93 General Fund appropriation for the City's employee health benefit contributions by \$1 million, reduce the 1992-93 General Fund appropriation by an additional \$518,000, and reduce the 1992-93 appropriation for other City funds by \$650,000. (Priority 1)

[Click On The Appropriate Box To View Item](#)

